BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of )
)
ARMCO STEEL CORPORATION )

Appearances:

For Appellant: Grady M. Bolding
Attorney at Law

For Respondent: Kendall E. Kinyon
Counsel

## O P I N I O N

This appeal is made pursuant to section 25666 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Armco Steel Corporation against proposed assessments of additional franchise tax in the amounts of $25,680.21, $12,474.80, $6,593.02, $6,044.41, $15,840.79, $10,535.46, $3,789.66, $11,031.18, and $53,832.44 for the income years 1967, 1968, 1969, 1969, 1970, 1970, 1971, 1971, and 1972, respectively.

Appeal-of Armco Steel Corporation

The issue presented for decision is whether respondent has properly refused to include the payroll and property factors of Reserve Mining Company in the combined report computations used to determine appellant's California income.

Appellant, Armco Steel Corporation, is headquartered in Middletown, Ohio. It is one of the five largest steel producers in the country. In 19.52, appellant joined Republic Steel Corporation, an unrelated company, in forming Reserve Mining Company. Reserve was formed as a "captive mining corporation" to mine and process taconite ore into iron concentrate pellets suitable for blast furnace use. Armco and Republic each owned 50 percent of Reserve's capital stock. All of Reserve's production of pellets was delivered to Republic and Armco at cost, and all funds necessary for Reserve's capital and operation were furnished by Republic and Armco in proportion to their respective 50-percent ownership interests.

During the appeal years, corporations such as Reserve, which were formed by two or more manufacturing concerns to supply ore, were deemed "captive mining corporations" by the Internal Revenue Service if the specific requirements of Revenue Ruling 56-542, 1956-2 Cum. Bull. 327, were met. The captive mining corporation was treated in effect as if it were a partnership for federal tax purposes. Thus, Reserve's federal income tax returns during the appeal years were information returns, and Republic and Armco reported their allocable shares of Reserve's income, deductions, and credits.

As stated above, one-half of Reserve's production during the appeal years was transferred to Armco at cost. Based upon the cost transfer, Armco determined that its apportionable income reported on its California franchise tax returns was increased because its cost of goods sold was reduced by the difference between the fair market value and the cost of Reserve's production transferred to Armco. Therefore, Armco included one-half of Reserve's property and payroll in the denominators of its own property and payroll factors. No sales were included since Reserve had no sales. Upon audit, respondent determined that Armco and Reserve were not unitary because Armco did not have more than SO-percent ownership control of Reserve. Based upon this determination, respondent eliminated Reserve's payroll and property factors from the 1972 combined report computation.

Respondent also proposed adjustments for the years 1967 through 1972 based upon federal audit adjustments and the inclusion of foreign corporations in the combined report.

Appellant contends that'fair apportionment of its income requires either that Reserve's property and payroll be included in appellant's factors, or that Reserve's true income, measured by the difference between the fair market value of Reserve's pellet production and the cost, be excluded from appellant's apportionable income. Respondent argues that the decision in the Appeal of Revere Copper and Brass, Incorporated, decided by this board on July 26, 1977, prohibits the inclusion of Reserve's property and payroll in appellant's factors, and that there is no basis for excluding Reserve's "true income" from appellant's tax base.

In the Appeal of Revere Copper and Brass, supra, the appellant was engaged in the business of fabricating nonferrous metals. It joined with a competitor to form a cost corporation to produce aluminum for use in their separate manufacturing businesses. Each owner held exactly 50 percent of the capital stock. In its California franchise tax returns, the appellant reported 50 percent of the payroll and 50 percent of the tangible property of the cost corporation in its respective factor denominators. We ruled that the appellant's 50-percent ownership of the stock did not give it controlling ownership of the cost corporation. Because there was no controlling ownership, the corporations were not unitary and the appellant was not entitled to include the cost corporation's property and payroll in its factors.

In the present case, appellant does not contend that it is unitary with Reserve. Appellant argues that Revenue and Taxation Code section 25137 should be applied to its case rather than the usual apportionment method. Section 25137 provides:

> If the allocation and apportionment provisions of this act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the Franchise Tax Board may require, in respect to all or any part of the taxpayer's business activity, if reasonable:
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> (a) Separate accounting;

(b) The exclusion of any one or more of the factors;

(c) The inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or

(d) The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

Appellant contends that section 25137 was designed to correct a situation such as- appellant's, where the income arising from the operations of Reserve is included in appellant's income without appellant being allowed to utilize Reserve's property and payroll factors in the apportionment of that income. Appellant argues that either subdivisions (a) or (d) of section 25137 may be invoked to exclude Reserve's true income. Alternatively, appellant argues that we should ignore Reserve's corporate form and treat Reserve as a partnership or joint venture in conformity with federal law by allowing Armco to include its share of Reserve's property and payroll factors in its apportionment formula.

In the Appeal of Revere Copper and Brass, supra, the appellant also argued that the corporate form of its cost corporation should be ignored and that it should be treated in the same manner as would a captive mining corporation under federal law. We reiterate here our statement in Revere that "we are unaware of any California case, regulation, or ruling which would allow such treatment, and neither amicus nor appellant has offered any." Further, we do not believe that section 25137 should be utilized to achieve indirectly this same result.

Apportionment under the standard. apportionment formula provisions of the Uniform Division of Income for Tax Purposes Act is the prescribed method. Deviation from the statutory allocation and apportionment procedures is authorized only in exceptional circumstances, and the party who seeks to invoke the applicability of section 25137 has the burden of proving that such exceptional circumstances are present. (Appeal of Borden, Inc., Cal. St. Bd. of Equal., Feb. 3, 1977;) The commentators and the draftsman of the Uniform Act clearly believe that the relief section should be narrowly construed. Keesling and Warren, in an article entitled

California's Uniform Division of Income for Tax Purposes Act, 15 U.C.L.A. L. Rev. 156, 171 (1967), state:

> There are completely compelling reasons for giving the relief provisions a narrow construction. Under a broad construction the purposes of obtaining uniformity through the adoption of the Uniform Act would be defeated. If a choice of methods is permitted, different administrators in different states inevitably will choose different methods. As a result, even if all the states imposing taxes on or measured by income should adopt the Uniform Act, the chaotic condition heretofore existing would continue to exist.
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> Professor Pierce, the draftsman of the Uniform Act, clearly was of the opinion that the relief provisions should be interpreted narrowly and were designed to permit the use of methods different than those prescribed in the Act only in unusual cases and in cases where the application of the specifically prescribed methods might be held unconstitutional. Shortly after the act was drafted he published an article discussing these provisions. He states that "[t]he Uniform Act, if adopted in every state having a net income tax or a tax measured by net income, would assure that 100 percent of income, and no more and no less, would be taxed." Obviously, this statement would not be true if the relief provisions were interpreted to give the administrators in the different states broad discretion in the selection of alternative methods.
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> Professor Pierce further indicates that the instances in which the prescribed methods may produce an unreasonable or unconstitutional result are apt to be rare. He warns also that:
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> > departures from the basic formula should be avoided except where reasonableness requires. Nonetheless, some alternative method must be available to handle the constitutional problem as well as the unusual cases, because no statutory pattern could ever resolve satisfactorily the problems for the multitude

> of taxpayers with individual business characteristics. (Footnotes omitted.)

We agree that the application of section 25137 should be limited to unusual cases or cases where imposition of the standard formula could be attacked on constitutional grounds. In the present case, appellant chose to form Reserve as a corporation, presumably to gain certain benefits. The business could have been formed either as a partnership or as a joint venture and appellant would have realized the tax advantage it now seeks. We do not believe that section 25137 should be applied simply so that appellant can avoid the tax consequences resulting from the form of business entity which it chose. (See Handlery v. Franchise Tax Board, 26 Cal.App.3d 970, 984 [103 Cal.Rptr. 465] (1972).) Appellant's situation does not fall into the narrow ambit reserved for the exceptional case which section 25137 was enacted to relieve.

## O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Armco Steel Corporation against proposed assessments of additional franchise tax in the amounts of $25,680.21, $12,474.80, $6,593.02, $6,044.41, $15,840.79, $10,535.46, $3,789.66, $11,031.18, and $53,832.44 for the income years 1967, 1968, 1969, 1969, 1970, 1970, 1971, 1971, and 1972, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 10th day of October , 1984, by the State Board of Equalization, with Board Members Mr. Nevins, Mr. Dronenburg, Mr. Collis, Mr. Bennett and Mr. Harvey present.

Richard Nevins, Chairman

Ernest J. Dronenburg, Jr., Member

Conway H. Collis, Member

William M. Bennett, Member

Walter Harvey*, Member

*For Kenneth Cory, per Government Code section 7.9